# Re: “Comments on draft rules for granting Foreign Tax Credit”

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To: The Director (TPL-IV),
Central Board of Direct Taxes,
Room No. 147-F, North Block,
New Delhi, India.

**Re: "Comments on draft rules for granting Foreign Tax Credit"**

Thank you for the opportunity to provide comments in response to the draft rules for the granting of foreign tax credits ("**Draft Rules**") under the Income Tax Act, 1961.

Perhaps the most egregious drawback in the Draft Rules is that it does not consider the erosive impact foreign losses could, in conjunction with the proposed mechanism of relief from double taxation, have on India's domestic tax base. It is demonstrated in the attached note that such a framework would be tantamount to financing private enterprise and foreign treasuries at the expense of the Indian treasury, which cannot be justified as a policy.

The Draft Rules also do not provide for any clarity in respect of excess foreign tax credits that taxpayers may accumulate in cases where their foreign sourced income may exceed their worldwide income due to losses incurred in operations carried on in India.

In the attached note, I attempt to explain these issues, and provide solutions that may be adopted in the revised rules. In Part 1, I highlight the lack of rules to recapture the domestic tax base in cases of foreign losses incurred by a tax resident of India, and arithmetically demonstrate the revenue loss that the treasury would incur in different scenarios on account of their absence. In Part 2, I propose a general mechanism, which would ensure that the domestic tax base is preserved despite foreign losses. The proposal contained in Part 2 may be susceptible to abusive practices, the antidote to which is proposed in the form of a specific anti-avoidance rule in Part 3. Part 4 briefly deals with the converse scenario in which a taxpayer may have an excess of foreign tax credits, making a case for more clear and equitable rules.

I hope you will find these comments useful.

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## 1. Problem: Erosion of Indian tax base

### 1.1. Introduction

Tax residents of India are liable to tax on their worldwide income. Therefore their tax base is determined by taking into account not only foreign profits, but also foreign losses. The Draft Rules would unabatedly erode the Indian tax base in cases where a tax resident of India incurs foreign losses, unless the rules are augmented by provisions to recapture India's domestic tax base. The rules should, therefore, exclude the availability of foreign tax credit to a taxpayer in financial years subsequent to the period over which the losses have been incurred as long as the revenue lost on account of foreign losses has not been recaptured. This is demonstrated in the following hypotheticals.

### 1.2. Ideal taxation

XCo, a company which is a resident of India, carries on business in India, and in State X through a permanent establishment. Its profits and losses from operations in both states over the period of two financial years are as follows.

| **Financial Year** | **India** | **State X** |
|---|---|---|
| FY1 | 300 | (200) |
| FY2 | 100 | 200 |

For the purposes of this hypothetical, we assume that the applicable tax rates in India and State X are 30% and 20% respectively.

XCo's Indian tax liability over the passage of the two years should *ideally amount* to:

30% of worldwide profits over FY1 and FY2 – 20% of State X profits over FY1 and FY2

= 0.3 (300 – 200 + 200 + 100) – 0.2 (–200 + 200)

= **120**

### 1.3. Erosion of Indian tax base

#### 1.3.1. General scenario

Considering that a taxpayer's tax liability is calculated for each financial year, XCo's Indian tax liability over the two years, under the Draft Rules, would be calculated as follows:

[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]

= [0.3 (300 – 200) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200)]

= **80 (revenue loss of 40, or 33.33%)**

As can be seen, the implementation of the Draft Rules as they are currently proposed would result in a revenue loss of 40, or 33.33% in the above hypothetical to the Indian treasury.

#### 1.3.2. Neutralising impact of carry-forward of losses in PE State

The foreign PE state would most likely allow for the carry forward of the PE losses, as is the case in the internal laws of most countries.[1] Even if the internal laws of a country do not allow for the carry forward of PE losses, it would be so required under the non-discrimination provisions of tax treaties.[2] The revenue loss illustrated in section 1.3.1 is likely to be abated in such scenarios, as only the foreign taxes actually *paid* can be credited against Indian taxes. To illustrate this, it is assumed that State X in the above hypothetical allows for a carry forward of losses for one year. Therefore, the taxable profit attributable to the PE in State X for FY2 would be 0. Consequently, the actual taxes paid in State X for FY 2 will also be 0, as would be the credit available in India. Therefore, XCo's Indian tax liability over the two years would amount to:

[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]

= [0.3 (300 – 200) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (0)]

**= 120 (no revenue loss)**

### 1.3.3. Reversal of the neutralising effect of time limits on carry forward of losses in PE State

In many countries, as in India, losses can be carried forward only for a limited period. These losses, upon the expiry of the carry forward period abroad, would no longer be usable in the foreign jurisdiction, resulting in the permanent erosion of the Indian tax base on account of foreign losses. To illustrate this, the facts of the above hypothetical are altered as follows:

| Financial Year | India | State X |
|---|---|---|
| FY1 | 300 | (200) |
| FY2 | 0 | 0 |
| FY3 | 100 | 200 |

As seen in section 1.2, XCo's Indian tax liability over the three financial years should ideally be 120. However, given that State X allows losses to be carried forward for one year in State X, the neutralising effect seen in section 1.3.2 would be reversed, should XCo not earn a profit through its PE in State X in FY2 to compensate the entirety of the PE losses suffered in FY1, as demonstrated in following calculation:

Indian tax liability over three financial years:

[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]
+
[30% of worldwide profits for FY3 – State X tax paid for FY3]

= [0.3 (300 – 200) – 0.2 (0)] + [0.3 (0) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200)]

**= 80 (revenue loss of 40, or 33.33%)**

### 1.3.4. Impact of carry back provisions of PE State on the Indian revenue

#### 1.3.4.1. Opening remarks

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1 See, for example: Section 72, Indian Income Tax Act, 1961; Article 20 of the Netherlands Corporate Income Tax Act; Section 45, United Kingdom Corporation Tax Act, 2010.

2 See: paragraph 40(c) of the Commentary on Article 24 of the 2014 OECD Model Tax Convention on Income and Capital.

The tax laws of some countries provide not only for the carry forward, but also for the carry back of losses. For example, the Netherlands allows for the carry back of losses for one year,[3] whereas the US allows for the carry back of losses for two years.[4] This is done through filing amended or revised returns for the preceding year(s). Consequently, profits of the previous financial year are reduced to the extent of the subsequent financial year's losses, up to the limit of the previous year's profits, and the corresponding taxes are reimbursed to the taxpayer. However, a foreign tax credit for the previous year's profits may already have been claimed by the taxpayer in India, and the issue that arises for interpretation is: what does one mean by "amount of taxes paid" in draft rule (1)? While draft rule (4) does state that the "[n]o credit shall be available in respect of any amount of foreign tax which is disputed in any manner by the assessee", a revised return is unlikely to come within the purview of a "foreign tax which is disputed". Thus, a refund claimed due to the carry back of foreign losses may permanently erode the Indian tax base to the extent of the carry back of losses in the PE State. This phenomenon is demonstrated by altering the facts of the hypothetical as follows:

| **Financial Year** | **India** | **State X** |
|---|---|---|
| FY0 | 200 | 200 |
| FY1 | 300 | (200) |
| FY2 | 100 | 200 |

In these facts, the amount of State X refund in received in FY1 = 0.2(200) = **40**. And the Indian tax liability over the three financial years in this case should <u>ideally amount to</u>:

30% of worldwide profits over FY0, FY1 and FY2 – 20% of State X profits over FY0, FY1 and FY2

= 0.3 (200 + 300 + 100 + 200 – 200 + 200) – 0.2 (200 – 200 + 200)

= **200**

The Draft Rules do not clarify how they would interact with tax systems providing for the carry back of losses. Three possibilities can be anticipated in this regard:

- The FY1 refund of FY0 taxes in State X, the credit for which is likely to have already been claimed in India, is ignored;
- The FY1 refund of FY0 taxes in State X is treated as XCo's income attributable to its PE in State X; and
- The credit provided in FY0 for the taxes paid in State X for that period is revoked upon their refund in FY1 in State X.

The Indian tax impact of each of these approaches is calculated below:

### 1.3.4.2. The refund is ignored

[30% of worldwide profits for FY0 – State X tax paid for FY0]
+
[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]

= [0.3 (200 + 200) – 0.2 (200)] + [0.3 (300 – 200) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200)]

= **160 (revenue loss of 40 or 20%)**

### 1.3.4.3. The refund amount is considered as XCo's income attributable to its PE in State X

[3] Article 20(2), Netherlands Corporate Income Tax Act.

[4] § 172(b)(1)(A)(i), US Internal Revenue Code.

The State X refund of 40 in FY1 would be treated as income attributable to XCo's PE. Therefore, XCo's worldwide income for FY1, according to India, would increase by 40, which it will seek to tax as such. However, State X, given that it does not perceive the refund of 12 as income, does not tax it. Therefore no credit will be available in India for the tax it levies on what it perceives as foreign sourced income. The Indian tax would thus be calculated as follows:

[30% of worldwide profits for FY0 – State X tax paid for FY0]
+
[30% of worldwide profits for FY1 (as increased by State X refund) – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]

= [0.3 (200 + 200) – 0.2 (200)] + [0.3 (300 – 200 + 40) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200)]

= **172 (revenue loss of 28 or 14%)**

#### 1.3.4.4. Credit availed in FY0 revoked upon State X tax refund in FY1

Under this approach, India would revoke the credit availed by XCo in FY0 as soon as the State X taxes are refunded in FY1. This would be based on the interpretation that taxes refunded could not be considered to fall within the term "amount of taxes paid" in draft rule (1). Thus the Indian tax liability over the three years would be calculated as follows:

[30% of worldwide profits for FY0 – State X tax paid for FY0]
+
[30% of worldwide profits for FY1 – State X tax paid for FY1 + State X taxes paid for FY0, but refunded in FY1]
+
[30% of worldwide profits for FY2 – State X tax paid for FY2]

= [0.3 (200 + 200) – 0.2 (200)] + [0.3 (300-200) – 0.2 (0) + 40] + [0.3 (100+200) – 0.2 (200)]

= **200 (no revenue loss)**

### 1.3.5. Closing remarks

There are jurisdictions such as the UK, Austria, Belgium, etc. in which losses may be carried forward indefinitely. Losses in such jurisdictions, as long as they are not artificially created, would not pose a great risk to the Indian tax base, as there would be no need to provide for a credit for foreign profits arising in subsequent financial years, to the extent the losses are not recovered. However, most countries do have time limits for the carry forward of losses, the expiry of which, under the current state of the Draft Rules, would result in the permanent erosion of the Indian tax base.

Irrespective of time limits on carrying forward losses, countries allowing for the carry back of losses pose a different set of problems explained in section 1.3.4 above. Evidently, the solution described in section 1.3.4.4 would be preferable to protect India's tax base. However, the Draft Rules are silent in this regard, which would lead to uncertainty in their interpretation and ultimately result in litigation. Even if the third approach were to be clearly adopted in the revised rules, its successful execution would depend either on the robustness of the exchange of information mechanism with the other state (in scenarios covered by tax treaties), or on the taxpayer's meticulousness in reporting the refund to the Indian tax authorities. Further, this approach resolves the erosion of the Indian tax base only in the case of carry back of losses in the other state, but not the scenarios discussed in sections 1.3.1 and 1.3.3. Therefore, a more holistic solution is desirable.

## 1.4. Conclusion

It is clear that the Draft Rules for claiming foreign tax credit leave much to be desired in terms of the protection of the Indian tax base, which can be seriously eroded on account of foreign losses. If realised, the revenue losses demonstrated through the hypotheticals in sections 1.3.1, 1.3.3, 1.3.4.2, and 1.3.4.3 would be tantamount to financing private enterprise and foreign treasuries at the expense of the Indian treasury, which cannot be justified as a policy.

## 2. Solution: Recapture of domestic tax base

### 2.1. Proposed mechanism

It is imperative for India to adopt a system of recapturing the Indian domestic tax base, as soon as the foreign operations of Indian taxpayers return to profitability. In other words, foreign tax credits should not be granted for foreign taxes paid on profits to the extent that foreign loss deductions were allowed against Indian profits in previous financial years. Given that such a denial of foreign tax credit is only a manifestation of the recapture of the previously lost domestic tax base, it would not result in a breach of tax treaty provisions for the relief from juridical double taxation, which do not concern themselves with the calculations and methods of dealing with losses etc.[5]

### 2.2. Applying the mechanism

#### 2.2.1. Opening remark

The mechanism of recapturing the Indian tax base, to the extent it may be eroded by foreign losses, is arithmetically illustrated below by applying it to each of the above hypotheticals in which such foreign losses resulted in loss of Indian revenue:

#### 2.2.2. Recapture of domestic tax base: hypothetical 1.3.1

XCo's profits and losses in the hypothetical examined in section 1.3.1 were:

| Financial Year | India | State X |
|---|---|---|
| FY1 | 300 | (200) |
| FY2 | 100 | 200 |

Applying the mechanism described in section 2.1, XCo's tax liability in India should be calculated as follows:

[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid (on State X profits reduced by FY1 losses) for FY2]

= [0.3 (300 – 200) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200 – 200)]

**= 120 (no revenue loss)**

#### 2.2.3. Recapture of domestic tax base: hypothetical 1.3.3

XCo's profits and losses in the hypothetical examined in section 1.3.3 were:

| Financial Year | India | State X |
|---|---|---|
| FY1 | 300 | (200) |
| FY2 | 0 | 0 |

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5 See: paragraphs 65 and 66 of the Commentary on Article 23 of the 2014 OECD Model Tax Convention on Income and Capital.

| | | |
|---|---|---|
| FY3 | 100 | 200 |

Applying the mechanism described in section 2.1, XCo's tax liability in India should be calculated as follows:

[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid (on State X profits, if any, reduced by FY1 losses) for FY2]
+
[30% of worldwide profits for FY3 – State X tax paid (on State X profits reduced by accumulated losses) for FY3]

= [0.3 (300 – 200) – 0.2 (0)] + [0.3 (0) – 0.2 (0 – 200)] + [0.3 (100 + 200) – 0.2 (200 – 200)]

= **120 (no revenue loss)**

### 2.2.4. Recapture of domestic tax base: hypothetical 1.3.4.1

XCo's profits and losses in the hypothetical examined in section 1.3.4.1 were:

| Financial Year | India | State X |
|---|---|---|
| FY0 | 200 | 200 |
| FY1 | 300 | (200) |
| FY2 | 100 | 200 |

Applying the mechanism described in section 2.1, XCo's tax liability in India should be calculated as follows:

[30% of worldwide profits for FY0 – State X tax paid for FY0]
+
[30% of worldwide profits for FY1 – State X tax paid for FY1]
+
[30% of worldwide profits for FY2 – State X tax paid (on State X profits reduced by FY1 losses) for FY2]

= [0.3 (200 + 200) – 0.2 (200)] + [0.3 (300 – 200) – 0.2 (0)] + [0.3 (100 + 200) – 0.2 (200 – 200)]

= **200 (no revenue loss)**

### 2.2.5. Conclusion

The proposed mechanism of recapturing the domestic tax base eroded by foreign losses would prevent consequent revenue losses. The procedure is fairly simple, and prevents revenue losses caused by reason of the expiry of the carry forward time limit in the foreign jurisdiction as well as those caused due to the carry back of losses.

## 3. Anti-abuse

### 3.1. Potential for abuse

The proposed mechanism of recapture of losses is not perfect in the sense that the recapture of the domestic tax base can be avoided by converting a foreign PE into a subsidiary, by way of a demerger, as soon as it returns to profitability.[6] This manoeuvre would prevent the recapture of the lost domestic tax base due to losses suffered by the foreign PE.

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6 This form of base erosion, and avoidance of recapture rules was seen in the Netherlands. See: Dr. René Offermanns, `Netherlands - Letter on possible corporate income tax measures published´, (11 Dec. 2009), News IBFD, available at:

It must be noted that there is no causal relationship between the proposed recapture rules and such abusive practices. The previous paragraph only shows that the abusive practices could be employed despite the recapture rules. Therefore, the possibility of such abusive practices should not in any way be seen as an inherent demerit of the proposed recapture rules. On the contrary, this section highlights the need to supplement the recapture rules with specific anti-avoidance rules.

### 3.2. Specific anti-abuse mechanism

The abusive conversion of a foreign PE into a subsidiary could be countered in two ways. The first approach would be to disallow the deduction of foreign losses. However, this may not be feasible insofar as they may exceed the delegated powers of the Central Board of Direct Taxes, whose task is to make rules concerning relief from juridical double taxation, and not the deductibility of foreign expenses. Be that as it may, such a preventive rule may not be desirable from a policy perspective as it is more likely to create cash flow problems for the carrying on of cross-border businesses through PEs.

Nonetheless, it may be specified in the revised rules that the deduction of losses attributable to a foreign permanent establishment, claimed by a resident taxpayer, would be retroactively revoked, should the taxpayer convert a PE into a subsidiary before the domestic tax base is recaptured. In order to ensure that foreign losses are not abused to permanently erode India's domestic tax base, it may be useful to amend the Income Tax Act, 1961 to expressly confer the authority to frame specific anti-avoidance rules to the Central Board of Direct Taxes.

## 4. Converse scenario: carry forward of excess foreign tax credits.

While it is important to preserve India's tax base on account of foreign losses, it is also important (and equitable) to preserve taxpayers' foreign tax credits, which may not be entirely usable[7] in the same financial year. Such a scenario could arise when a taxpayer incurs losses from its Indian operations, but is profitable in its operations abroad. Such usable, excess foreign tax credits should be preserved by allowing them to be carried forward to subsequent financial years. While the Draft Rules do not preclude such carry forward of excess foreign tax credits, they are entirely silent in this regard. With a view to avoiding any controversy in this regard, it is desirable to clearly state in the revised rules that the carry forward of usable, excess foreign tax credit is permitted.

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http://online.ibfd.org/document/tns_2009-12-11_nl_3; and Dr. René Offermanns, `Netherlands - Tax Plan for 2012 – details´, (21 Sep. 2011), News IBFD, available at: http://online.ibfd.org/document/tns_2011-09-21_nl_1.

[7] Usable excess foreign tax credits should not be confused with unusable foreign tax credits. The latter are a result of a higher tax levied in the foreign jurisdiction on the same income, which is not the scenario one is concerned with in this section.